

ICPS newsletter

ICPS proposes a strategy to fight illegal tobacco import and circulation

During the past two years, the illegal import and circulation of tobacco products has grown significantly in Ukraine. This has resulted in huge losses, due to reduced state budget revenues and decreased returns on investment for Ukraine's tobacco industry. The quantity of illegal tobacco products available in the Ukrainian market demands the development of a strategy that would reduce this phenomenon. The International Centre for Policy Studies was commissioned by the Coalition for Property Rights to conduct research on "The Origins and Consequences of Illegal Tobacco Import and Circulation in Ukraine". Last week, the results of this study were presented to the public

The problem and its origins

The tobacco industry is important to Ukraine's economy. The share of Ukraine's tobacco industry in the gross output of goods and services is less than 1%. However, the contribution of tobacco companies to state budgets at all levels makes up 3% of consolidated budget revenues; and foreign direct investment (FDI) in the industry amounts to 5% of total FDI into Ukraine. Foreign investments have modernised the industry and established cigarette production based on modern technologies. However, the existence of a large black market of tobacco products has resulted in a significant under-utilisation of capacity and reduced the industry's investment attractiveness.

Illegal cigarettes account for over a quarter of consumption. According to ICPS calculations, the illegal supply of tobacco products in Ukraine during 1999 amounted to approximately 18.6 billion sticks, or 27% of total consumption. The illegal supply of cigarettes consisted almost entirely of illegal imports, mostly cheap non-filter cigarettes (about 94% of the total amount).

The illegal import and sale of cigarettes result in huge losses.

Losses from the illegal import and sale of tobacco products in Ukraine are very large. Tobacco producers in Ukraine lose due to reduced profits and returns on investments, while consumers lose due

to higher health hazards and a lack of quality guarantees. In general, society loses due to the underfunding of public services (lower budget revenues), inefficient state health care, and the criminalisation of society. Those who benefit represent a small group involved in the illegal import and sale of tobacco products.

The sale of illegal cigarettes is facilitated by differences in excise rates, and by other conditions. ICPS divides the causes of illegal tobacco circulation in Ukraine into incentives and conditions. Incentives give rise to activities associated with the illegal import or sale of tobacco products and entry of new participants in this sphere. The incentive is the opportunity to receive profits from illegal sales of tobacco products due to differences in excise rates. Conditions are factors that enable profit-making opportunities. Such conditions include ineffective existing mechanisms for disclosing and punishing illegal importers and distributors of tobacco products. The lack of a mechanism for destroying seized tobacco products also poses the threat of resumed legal sales of products which are harmful for human health.

Policy alternatives

State policy for combating the illegal import and circulation of tobacco products can be aimed at either eliminating incentives (for example, reducing the excise rate for non-filter

cigarettes), or eliminating conditions for conducting illegal operations. These alternatives should be evaluated on the basis of the total effect on society. The researchers concluded that reducing excise rates will lead to a significant decrease in state budget revenues and will have a negative effect on Ukrainian society as a whole. Hence, it is proposed to concentrate effort on eliminating conditions for the illegal import and sale of tobacco products. Such measures will have long-term positive effects, since they will enable both the reduction of existing volumes of illegal imports and sales, and ensure the prevention of illegal operations in the future, as well as promote the resolution of other societal problems.

Option 1. Excise rate reduction

ICPS experts believe that although the reduction of the excise rate for non-filter cigarettes will enable the temporary elimination of illegal imports, it will also lead to decreased budget revenues and will have negative effects on society as a whole. Their calculations show that if excise rates for non-filter cigarettes in Ukraine and Russia had been equalised, in 1999 budget revenues from excise on non-filter cigarettes would have dropped from UAH 230 million de facto collected to approximately UAH 45 million. In general, budget revenues from the production of non-filter cigarettes (including excise, VAT, and obligatory 5% deducted to the Pension Fund) would drop from UAH 438 million down to UAH 332 million, or by approximately 25%.

Excise reduction would contradict the objective of harmonising Ukrainian and European legislation. Such changes in taxation will reduce the stability of Ukrainian taxation policy, because they contradict the strategic directions of its development and make the policy dependent upon decisions made by Russian authorities.

Option 2. Eliminating conditions for illegal operations

Eliminating conditions for the illegal import and sale of tobacco products (i.e., transparency of borders, low performance of law enforcement agencies, poor punishment mechanisms, overregulation of legal tobacco trade) will enable a permanent reduction in the scale of this phenomenon. Moreover, these measures will also help to resolve other social problems such as contraband in arms, drugs and alcoholic beverages, illegal migration, and illegal import of other products.

Recommendations

ICPS believes that the action plan for combating the illegal import and circulation of tobacco products in Ukraine should embrace four steps.

1. Increasing law enforcement effectiveness. If the effectiveness of law enforcement agencies is raised, we should expect an increase in the probability of disclosure and punishment of individuals involved in the illegal import and circulation of tobacco products. The efforts should be concentrated on disclosing criminal groups involved in the organisation of illegal import and distribution of tobacco products. Hence, there is a crucial need for increasing the performance of the State Customs Service and State Tax Administration.

The State Customs Service will be more capable of disclosing groups involved in the organisation of illegal imports if case it is granted the authorities envisaged in the draft of the new Customs Code of Ukraine: the right to conduct intelligence and the right to conduct customs controls not only at cross-border checkpoints, but around border zones as a whole. The structure of the tax police should be expanded to include a special department for combating the illegal circulation of alcoholic beverages and tobacco products.

Expanding authorities should be accompanied by measures for preventing corruption in law enforcement agencies. International experience indicates that effective methods for preventing corruption include clear instructions regarding activities at each level of decision making, and conducting a personnel policy envisaging unprejudiced

competitive selection of staff and staff rotation.

2. Simplifying conditions for the legal trade of tobacco products. ICPS expects the simplification of conditions for legal trade in tobacco products in Ukraine after the implementation of the Law "On the licensing of some economic activities", approved by the Verkhovna Rada on June 1, 2000.

If the law on licensing is implemented and cost of the license is set at the level of administrative expenditures, the risks and expenses associated with illegal trade will exceed payments for conducting legal activities. Consequently, more businesses will prefer legal activities. Entrepreneurs will create workplaces and employ individuals who were otherwise induced to earn their living in illegal retail trade.

The expansion of legal trade will facilitate better controls by licensing and tax authorities over the circulation of tobacco products. Hence, retailers and wholesalers will be more reluctant to distribute illegal products, given the threat of losing their license and being punished by tax authorities. Moreover, legal traders will become a significant force interested in eliminating illegal tobacco circulation, and will actively assist law enforcement agencies in this field.

3. Improving mechanisms for punishing the illegal import and circulation of tobacco products. Higher penalties will reduce the profits and increase the risks and cost of concealment for individuals involved in the illegal import and circulation of tobacco products. Methods for making penalties more severe include:

- choosing optimal penalties (fines). The optimal fine for illegal operations with tobacco products should be sufficiently high to affect offender activity and deprive individuals of operating funds for continuing illegal activities. On the other hand, the fine should be realistic;
- hastening court trials on the seizure of illegal tobacco products. ICPS proposes to establish specialised administrative courts for considering cases on administrative offences only. If this is implemented, the duration of court trials on illegal imports and circulation of tobacco products will shrink, promoting more effective punishment;

- obligatory destruction of seized tobacco products. International experience indicates that destroying seized tobacco products increases the effectiveness of the struggle against illegal tobacco circulation. Alternatives for financing the destruction of seized tobacco products include: (1) destruction at the expense of the offender and (2) destruction financed from fine proceeds. Destruction at the expense of the offender will increase the size of penalties. If offenders have no funds, destruction can be financed from fine proceeds;

- formation of a negative public attitude towards the illegal import and circulation of tobacco products.

4. Increasing the protection of state borders. Increasing the protection of Ukrainian borders with Russia, Moldova, and Belarus is a long-term objective which emerges given Ukraine's policy of European integration and its need to ensure the security and health of people and the protection of Ukrainian producers from unfair competition.

In the short run, in order to increase the protection of the Ukrainian border and establish conditions for detecting the illegal import of tobacco products, ICPS proposes to implement the following measures:

- concentrate the efforts of customs service and frontier troops on the borders with Russia and Moldova, while reducing resources channelled to defence of the western border;
- change the timetables of cross-border trains. In order to ensure thorough customs control, the time assigned for customs controls should be extended (in particular, regarding local trains). This measure requires agreements between "Ukrzaliznytsia" (the Ukrainian state railways agency) and the State Customs Service;
- improve information exchange and co-operation between the State Customs Service of Ukraine and customs services of neighbouring countries. ■

For more information please contact Hlib Vyshlinsky (hlib@icps.kiev.ua, tel.: 463-6337) or Tetiana Sytnyk (tsytnyk@icps.kiev.ua, tel. 463-5966).

If you wish to obtain a full version of the research, please forward a request with your contact information to: marketing@icps.kiev.ua.